United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

ORIGINAL

76-7439

To be argued by:
MARC P. CHERNO

IN THE

United States Court of Appeals

For the Second Circuit

JOHN SCHLICK, individually and on behalf of all purchasers of the common stock of CONTINENTAL STEEL CORPORATION similarly situated,

Plaintiff-Appellee,

v.

PENN-DIXIE CEMENT CORPORATION, JEROME CASTLE, DANIEL H. ESCHEN, OMAR J. GLANTZ, JAMES C. JACOBSEN, HARVEY KUSHNER, ALFONSO J. MARCELLE, OLIVER K. PARRY, PAUL WINDELS, JR., GEORGE C. GREEN, ERIC M. JAVITS, JAMES F. MORRILL,

Defendants,

PENN-DIXIE INDUSTRIES, INC. (formerly Penn-Dixie Cement Corporation), JEROME CASTLE, OMAR J. GLANTZ, JAMES C. JACOBSEN, HARVEY KUSHNER, ALFONSO J. MARCELLE, JAMES F. MORRILL,

Defendants-Appellants.

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TABLE OF CONTENTS

PAGE

POINT I—A Plaintiff Who Has Knowingly Participated in the Conduct Complained of is Not a Proper Class Representative 1

(a) Plaintiff's disability is not cured because he only participated in certain of the challenged acts 1

(b) The cases uniformly hold that a plaintiff who knowingly participated in the challenged conduct cannot be a class representative 5

(c) Plaintiff's inadequacy cannot be avoided by judicial monitoring of his conduct or polling of class members 7

POINT II—The Court's Order is Plainly Appealable 10

CONCLUSION 16

Table of Cases Cited

American Pipe & Construction Co. v. *Utah*, 414 U.S. 538 (1974) 10

Blue Chip Stamps v. *Manor Drug Stores*, 421 U.S. 723 (1975) 12

Blum v. *Morgan Guaranty Trust Co.*, 539 F.2d 1388 (5th Cir. 1976) 5

Cinema 5, Ltd. v. *Cinerama, Inc.*, 528 F.2d 1384 (2d Cir. 1976) 4

Domaco Venture Capital Fund v. *Teltronics Services, Inc.*, 74 Civ. 3014, *noted in* CCH Fed. Sec. L. Rep. ¶ 95,687 (S.D.N.Y. Aug. 11, 1976), *appeal pending*, Docket No. 76-7462 (2d Cir.) 10

duPont v. *Wyly*, 61 F.R.D. 615 (D. Del. 1973) 4

Eisen v. *Carlisle & Jacquelin*, 417 U.S. 156 (1974) .. 10

Eisen v. *Carlisle & Jacquelin*, 391 F.2d 555 (2d Cir. 1968) 7

PAGE

First American Corporation v. *Foster*, 51 F.R.D. 248 (N.D. Ga. 1970) 6

G.A. Enterprises, Inc. v. *Leisure Living Communities, Inc.*, 517 F.2d 24 (1st Cir. 1975) 5, 8

General Motors Corp. v. *City of New York*, 501 F.2d 639 (2d Cir. 1974) 13

Handwerger v. *Ginsberg*, 519 F.2d 1339 (2d Cir. 1975) 14

Herbst v. *International Telephone & Telegraph Corp.*, 495 F.2d 1308 (2d Cir. 1974) 12, 15

Hornreich v. *Plant Industries, Inc.*, 535 F.2d 550 (9th Cir. 1976) 5

Kohn v. *Royall, Koegel & Wells*, 496 F.2d 1094 (2d Cir. 1974) 12, 14

Lamb v. *United Security Life Company*, 59 F.R.D. 25 (S.D. Iowa 1972) 6

In re Master Key Antitrust Litigation, 528 F.2d 5 (2d Cir. 1975) 12

Maynard, Merel & Co. v. *Carcioppolo*, 51 F.R.D. 273 (S.D.N.Y. 1970) 6

Nolen v. *Shaw-Walker Co.*, 449 F.2d 506 (6th Cir. 1971) 5

Parkinson v. *April Industries, Inc.*, 520 F.2d 650 (2d Cir. 1975) 11, 12, 15

Popkin v. *Bishop*, 464 F.2d 714 (2d Cir. 1972) 9

Popkin v. *Wheelabrator-Frye, Inc.*, CCH Fed. Sec. L. Rep. ¶ 94,091 (S.D.N.Y. 1973) 9

Sanders v. *John Nuveen & Co., Inc.*, 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972) 6

Statutes and Authorities Cited

Federal Rules of Civil Procedure:

Rule 23 ..... 7, 8

IN THE

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Defendants-Appellants.

REPLY BRIEF OF THE APPELLANTS

POINT I

A Plaintiff Who Has Knowingly Participated in the Conduct Complained of is Not a Proper Class Representative.

(a) Plaintiff's disability is not cured because he only participated in certain of the challenged acts.

Plaintiff necessarily recognizes that "[t]his appeal raises serious and important questions in the still changing

area of Rule 23'' (Pl. Br. 4-5).* Moreover, plaintiff is unable to cite any decision in which a court has certified as a class representative a plaintiff who admits that he has acted ''contrary to [his] opinion and beliefs as to what was in the best interests'' of the class members with respect to the subject matter at suit (App. 62a). And plaintiff's brief does not even attempt to treat with the basic problem that a class representative who faces personal liability on the basis of his admitted participation in the allegedly wrongful conduct is subject to an inherent and irreconcilable conflict between the protection of class interests on the one hand, and the protection of his own interest in avoiding liability on the other—a conflict which will necessarily call into question the binding effect of any judgment that defendants might obtain.

In this situation, it is no answer to say that plaintiff only participated in certain of the allegedly wrongful conduct, and that other wrongs are alleged in which he did not personally participate. For whatever the extent of his participation—be it in 10%, 30%, or 50% of the challenged conduct—the overriding fact is that plaintiff is simply not in a position to make litigation decisions such as which claims to stress and which to de-emphasize or ignore, without the taint of conflicting personal interest.

Indeed plaintiff's brief itself, in its effort to minimize or completely ignore the conduct in which he admittedly participated, is a telling exemplar of this conflict in operation. Thus, he now refers to the dividend reduction, which once had such a prominent place in his litany of wrongdoing, as ''at best a side bar'' in the overall ''scheme'' (Pl.

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* References to plaintiff's brief are designated "Pl. Br.". References to appellants' appendix are preceded by "App.".

Br. 7).* What is worse, he completely omits from his table of misconduct (Pl. Br. 7-8) one of his principal allegations —that Penn-Dixie caused Continental to sell steel products to it under unduly favorable terms and conditions (App. 258a)—obviously because plaintiff has testified that he was aware of and acquiesced in the alleged practices, which supposedly took place during his tenure, and, in fact, "was involved in" the operations in question (App. 64a). And plaintiff understandably makes no mention whatever of the conceded fact that he personally authorized, planned, negotiated and implemented the stock acquisition which gave Penn-Dixie its majority stock control over Continental, at a time when he says he knew that Penn-Dixie was engaged in "highly improper" practices relating to Continental, with a view toward the ultimate merger of the companies.**

But all of this is ultimately beside the point, except as a further demonstration that the conflict inherent in plaintiff's position has already gone far beyond the "potential"

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* As we pointed out in our initial brief, the dividend was first reduced at a time when plaintiff, by his own testimony, was in charge of the financial policies for the Penn-Dixie organization (App. 137a). A reduced dividend was again declared when plaintiff, as a member of the Continental Board, cast a vote which he testified that he knew was "contrary to" the best interests of Continental shareholders (App. 62a). It is difficult to understand, in light of this testimony, how plaintiff can say that "[n]owhere, however, can the appellants point to some knowing conduct on Schlick's part in voting for the dividend reduction as part of that scheme" (Pl. Br. 8).

** Even aside from its omissions, plaintiff's table is grossly misleading. Thus, for example, in his effort to minimize the relative importance of the transactions in which he participated, he takes one claim, relating to the Continental pension fund, and transforms it into three (items 4, 6 and 7) and does the same thing with a single claim relating to compensating balances (items 1 and 10). And even taking the chart at face value, almost all of the allegedly wrongful acts took place at a time when another client of plaintiff's counsel who has also brought suit against the defendants, John Weldon, was a member of Continental's Board.

or "theoretical."* For conflicts which are intrinsic and irrevocable cannot be measured by mathematical formulae, and a conflict remains a conflict whether a plaintiff has participated in two, five or seven of the acts in question. As one Court put it, "the assurance demanded by due process and Rule 23 is that the representative party in a class action must be free of *any interest* which holds the potential of influencing his conduct of the litigation in a manner inconsistent with the interests of the class."**

A meaningful analogy can be drawn, again, to the recent decisions of this Court involving the disqualification of counsel in "conflict" situations. In these situations the conflict would hardly be cured if, for example, the confidential information the attorney had access to involved only one transaction out of three or four at suit, or if the two conflicting lawsuits had only a partial similarity of issues. Indeed, in *Cinema 5, Ltd.* v. *Cinerama, Inc.*, 528 F.2d 1384 (2d Cir. 1976), where the Court held that disqualification was required when an attorney was a partner in one law firm which represented a client in one controversy, and also in another firm which opposed this client in another matter, the Court expressly rejected the argument that the conflict was not "substantial" since the controversies were dissimilar. Rather, the Court found that even if the attorney's personal participation in representing conflicting interests was "minimal", "inadvertent", and involved "no actual wrongdoing", disqualification must still result if

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* As we noted in our principal brief (p. 10n), any such conflict is in reality a "present" one from the outset of a litigation, when a plaintiff determines whom to name as defendants. In the present case, for example, plaintiff, for obvious reasons, chose not to name as defendants the directors of Continental at the time of the dividend reduction.

** *duPont* v. *Wyly*, 61 F.R.D. 615, 624 (D. Del. 1973), emphasis added.

there was even the slightest possibility that there would be "compromising influences or loyalties" in making litigation judgments.

The conflict in the present case can no more readily be wished away, disregarded, or minimized merely because it may only relate to some of the conduct under attack. In fact, the conflict inherent in this case is far more fundamental—plaintiff is not only already the subject of counterclaims by the defendants on the basis of his testimony, but is an obvious target for claims by putative class members themselves, since he is the only person who has already admitted that he knowingly acted to injure them.

(b) The cases uniformly hold that a plaintiff who has knowingly participated in the challenged conduct cannot be a class representative.

Turning briefly to the cases, the critical fact is, as noted, that plaintiff can cite no case which has granted class action certification when the proposed class representative concedes that he has intentionally acted contrary to the interests of the class with respect to the matter in suit. Moreover, plaintiff has not even attempted to deal with the cases, discussed at pp. 16-21 of our principal brief, which have uniformly denied class action certification in similar situations. Indeed, recent decisions by four different Courts of Appeals show that representative status must be denied in view of potentially antagonistic interests even when the conflict, unlike that in the present case, does not relate to the subject matter of the litigation.*

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* See, *G.A. Enterprises, Inc.* v. *Leisure Living Communities, Inc.*, 517 F.2d 24 (1st Cir. 1975); *Hornreich* v. *Plant Industries, Inc.*, 535 F.2d 550 (9th Cir. 1976); and *Nolen* v. *Shaw-Walker Co.*, 449 F.2d 506 (6th Cir. 1971), discussed at pp. 12-15 of our principal brief, and *Blum* v. *Morgan Guaranty Trust Co.*, 539 F.2d 1388 (5th Cir. 1976).

The cases which plaintiff does cite hardly reach or suggest a different result. Thus, in *Lamb* v. *United Security Life Co.*, 59 F.R.D. 25 (S.D. Iowa 1972), the first case cited, the Court found that the one person among several plaintiffs who had previously been a director of the corporation in question, far from conceding that he deliberately acted contrary to stockholders' interests, was himself allegedly a "victim of fraud and misrepresentation not distinct from the rest of the stockholders," and that he was, in any event, "only one of a group of plaintiffs seeking to represent the class."

In *Maynard, Meret & Co.* v. *Carciappolo*, 51 F.R.D. 273, 277 (S.D.N.Y. 1970), the Court, quoting this Court, noted that "[s]ince all members of the class are to be bound by the judgment, diverse and potentially conflicting interests within the class are incompatible with the maintenance of a true class action"; the Court did not remotely purport to say that the conflict there found to be disqualifying, which related to the nature of the relief sought, was the only type of "potentially conflicting" interest which would require this result, and did not, of course, suggest that a plaintiff's desire to avoid huge personal liability would not be equally disqualifying.

In *Sanders* v. *John Nuveen & Co., Inc.*, 463 F.2d 1075, 1081 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972), the Court held that it was "clearly improper" for persons with "conflicting and antagonistic interests" to the class to be class representatives. In *First American Corp.* v. *Foster*, 51 F.R.D. 248, 250 (N.D. Ga. 1970), the Court pointed out that "antagonism between plaintiffs and other class members" defeats a class action motion when this conflict is—as in the present case—"as to the subject matter of the suit." And in none of the other cases relied on was it claimed, much less conceded, that the plaintiff had participated in any of the conduct under attack.

In sum, the cases which have considered the question presented here—whether a person who has intentionally participated in certain of the allegedly wrongful conduct can be a proper class representative—have reached the clear and uniform result of disqualification.*

(c) Plaintiff's inadequacy cannot be avoided by judicial monitoring of his conduct or polling of class members.

We turn, finally, to plaintiff's thought that even if there is a conflict, the resulting due process defects can somehow be "cured" by having the court continually "monitor" all of the proceedings to determine how plaintiff is performing his function and exercising his judgment, with the aid, perhaps, of "polling" the absent class members from time to time "as to the vitality of their representative's actions" (Pl. Br. 19).

This suggestion would, we submit, turn Rule 23 on its head. Rule 23(a) contemplates that a plaintiff may be designated a class representative "only if" the court first concludes that he has no "interests antagonistic to those of the remainder of the class" (*Eisen* v. *Carlisle & Jacquelin*, 391 F.2d 555, 562 (2d Cir. 1968))—and not that a plaintiff having antagonistic interests will first be designated and then "monitored".

Moreover, it hardly furthers judicial economy or administration to grant class action status, with all of its attendant expenditures and burdens, in a situation where it

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* We should at this point dispose of several straw men that plaintiff constructs in an effort to avoid this issue. Defendants do not question certification because plaintiff "knows too much" (Pl. Br. 5), "can read a financial statement" (Pl. Br. 5), or is a "sophisticated investor" (Pl. Br. 25). Rather, defendants challenge certification because of plaintiff's own testimony that he knowingly participated in the conduct at issue. If there is any "character assassination" (Pl. Br. 14-15), it is plaintiff himself who is wielding the knife.

is most likely that it will have to be reconsidered. Further, while plaintiff curiously describes his monitoring and polling procedure as "a well-trod path" in this area (Pl. Br. 19), the fact is that there are *no* cases which have granted class action status in the face of an antagonistic or conflicting interest in the hope that the court, through day-to-day supervision, can somehow safeguard the rights of all concerned—any more than an attorney in a "conflict" situation is nevertheless allowed to proceed on the theory that the court, by some kind of periodic review of the litigation, can determine each week or month whether he is actually using confidential information.

Indeed, as the Court in *G.A. Enterprises, Inc.* v. *Leisure Living Communities, Inc.*, 517 F.2d 24, 27 (1st Cir. 1975), pointed out, no court could conceivably perform—nor should it be asked to perform—any such "monitoring" function of reviewing the conduct of litigation on a day-to-day basis to determine whether the plaintiff is taking the right depositions, asking the right questions, making the right motions, and pressing the right claims. Nor—putting to one side the burdens in time, effort and money—could the absent class members who are to participate in plaintiff's "polling" process conceivably be in a position to exercise a meaningful, informed judgment as to how plaintiff was making the daily decisions required throughout the course of a complex litigation.

In short, it is clear that such a procedure, assuming *arguendo* that it were practicable, does not meet the due process requirements that even plaintiff concedes must be controlling.* The mandate of Rule 23 is clear: the class

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* As plaintiff states, a

> ". . . genuine area of concern that the appellants have raised is the area of the relationship of class actions, procedural due process and *res judicata*. The appellants are indeed entitled to know that if they win, their victory will bind absent class members" (Pl. Br. 18).

representative must "fairly and adequately protect the interests of the class." In this case plaintiff does not fall within the parameters of this mandate. No amount of polling of class members, judicial overseeing of litigation or other legal legerdemain can overcome this basic disability. In a real sense plaintiff presents a procedure designed to waive the rights of absent class members or estop them from asserting those rights at a later date. We seriously question the propriety of such a procedure—which may well result in double exposure to defendants.

This is precisely what happened in the *Popkin* litigation (discussed at pp. 24-25 of our principal brief). There, in the initial action, the Court, after notice had been sent to all shareholders affording them the opportunity to object or express their views, found that certain merger exchange ratios were fair and reasonable. This Court, in a subsequent action brought by another plaintiff, then suggested that the initial court order would not prevent a shareholder from attacking the fairness of the merger in another action, since the plaintiff in the initial action was in a conflicting position in that he was also a shareholder of another of the four constituent corporations to the merger. *Popkin* v. *Bishop,* 464 F.2d 714, 720-721 (2d Cir. 1972). The District Court subsequently held, following this Court's lead, that plaintiff was free to maintain a new class action, although no showing was made that the plaintiff in the first action had not, in fact, adequately represented shareholders' interests, since "to hold otherwise would amount to a violation of due process." *Popkin* v. *Wheelabrator-Frye, Inc.,* CCH Fed. Sec. L. Rep. ¶ 94,091, at p. 94,371 (S.D.N.Y. 1973).

Popkin and the other cases discussed in our principal brief teach that where, as here, the plaintiff has an inherent and fundamental conflict, there is, in effect, a conclusive

presumption that due process requirements have not been met, irrespective of whether there is proof that plaintiff has not in fact been an adequate representative. We submit that this presumption—founded on the principle that a representative's loyalty must be absolutely undivided if absent class members are to be bound by a judgment—is plainly applicable to the present case.*

POINT II

The Court's Order is Plainly Appealable.

On October 19, 1976, this Court, after argument, denied plaintiff's motion to dismiss the appeal for want of an appealable order, without prejudice to renewal of the motion to the panel hearing the appeal. At the conclusion of his present brief, plaintiff now renews his request that the appeal be dismissed.

Plaintiff's argument, in essence, is that the appeal presents only "a 'routine' class action determination" which deals "simply with the exercise of a District Court's discretion concerning the presence of all of the elements of a class action" (Pl. Br. 28). This is a sharp contrast indeed with his concession that this appeal "raises serious and important questions in the still changing area of Rule 23" (Pl. Br. 4-5), and with the appeal by the same counsel in *Domaco Venture Capital Fund* v. *Teltronics Services, Inc.*, 74 Civ. 3014 (S.D.N.Y. Aug. 11, 1976), from an order *deny-*

* Plaintiff's disqualification as class representative would not, of course, prevent other shareholders from suing, any more than disqualification of counsel prevents the party in question from continuing the action with other counsel. Indeed, shareholders are not prejudiced in any way, since in light of *American Pipe & Construction Co.* v. *Utah*, 414 U.S. 538 (1974), and *Eisen* v. *Carlisle & Jacquelin*, 417 U.S. 156, 176n.13 (1974), the statute of limitations has been tolled during the pendency of this action.

ing class action designation on the identical issue as defendants raise here. Counsel apparently believes that the determination of this issue, at least when contrary to plaintiffs' position, is neither "routine" nor "simple", and is most certainly appealable.

Both sides agree, in any case, that "serious and important questions" are raised—questions which have not yet been expressly ruled upon by this Court and which have resulted in determinations by the district courts inconsistent with the result reached here. And, putting characterizations aside, both sides also agree that the standards for appealability are those set forth in *Parkinson* v. *April Industries, Inc.*, 520 F.2d 650, 656 (2d Cir. 1975):

> "(1) whether the class action determination is 'fundamental to the further conduct of the case';
>
> "(2) whether review of that order is 'separable from the merits';
>
> "(3) whether the order will cause 'irreparable harm to the defendant in terms of time and money spent in defending a huge class action.'"

Plaintiff does not and could not question that the first and third of these tests are clearly met here. As to the first factor, fundamentality—that the suit probably would not be continued if class action status is denied—plaintiff has continually said, in his papers and otherwise, and has never denied, that this action would be abated if he is found to be an improper class representative.*

Similarly, plaintiff does not question that the third criterion—"irreparable harm to the defendant in terms of

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* See, for example, plaintiff's moving papers on the motion to dismiss the appeal, where his counsel describes this appeal as a "reverse death-knell' appeal."

time and money spent in defending a huge class action" —is also obviously met. As this Court has noted, one irreparable consequence of an erroneous class action designation in a case such as this is, of course, the possibility that the *in terrorem* effect of a devastatingly large class damage claim will force the settlement of wholly meritless litigation. *See, e.g., Herbst* v. *International Telephone & Telegraph Corp.*, 495 F.2d 1308, 1313 (2d Cir. 1974), and authorities cited therein. See generally, *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739-741 (1975). Here, plaintiff has claimed damages for the class in excess of $20,000,000—over 20% of Penn-Dixie's net stockholders' equity as of December 31, 1975—the type of claim which could, as the Court in *Parkinson* notes, "in realistic terms . . . force the defendant to settle plaintiffs' claims regardless of the merits of the plaintiffs' cases" (*Parkinson, supra,* 520 F.2d at 654).* Moreover, wholly apart from the *in terrorem* effect of an erroneous class action designation, defendants face enormous and potentially unnecessary discovery burdens—plaintiff has indicated that he will demand extensive documentary and deposition discovery with respect to literally hundreds of business transactions which he claims are part of a multi-year "scheme" to depress the value of Continental's stock.** In short, as plaintiff recognizes, this criterion is also clearly satisfied.

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* By contrast, in the *Parkinson* case itself, the Court found that the "size of potential recoveries . . . will not be devastatingly large" (520 F.2d at 654n.2). Similarly, in *Kohn* v. *Royall, Koegel & Wells*, 496 F.2d 1094 (2d Cir. 1974), the class—those persons allegedly denied employment by a particular law firm by reason of their sex —was a relatively small one, particularly as compared to the over 1,000,000 shares involved here.

** Compare the present case, where discovery is largely in the future, with *In re Master Key Antitrust Litigation*, 528 F.2d 5, 13 (2d Cir. 1975), where pretrial discovery was already substantially complete, and *Parkinson, supra,* where the Court found that discovery proceedings presented the prospect of "only a little additional expense to the defendants" (520 F.2d at 565).

Plaintiff's only argument is that the second test—whether review of the order is "separable from the merits"—has not been satisfied. His contention in this regard is that the court, in order to determine whether a plaintiff who has participated in the allegedly wrongful conduct can be a proper class representative, must also necessarily determine whether that conduct was wrongful. As plaintiff puts it, "Thus if Schlick was, as the appellants allege, a participant in an unlawful scheme must not a finding necessarily be made that there was a scheme in the first place?" (Pl. Br. 28.)

We respectfully submit that this contention is nothing short of absurd. The present appeal requires no determination that any conduct is wrongful; indeed, defendants believe most strongly that there has been no wrongful conduct at all. Rather, this appeal presents only one succinct and most separable question—whether a plaintiff who has admittedly and knowingly participated in the conduct which he complains of can possibly be a proper class representative, accepting *arguendo* plaintiff's own testimony as to this conduct, *and irrespective of whether the conduct in question is ultimately found to be wrongful.*

That this does not fall afoul of the separability requirement is obvious from the cases which have discussed this element. In *General Motors Corporation* v. *City of New York*, 501 F.2d 639, 645 (2d Cir. 1974), an antitrust case, the basis for the appeal was that the "common questions" requirement of Rule 23(b)(3) had not been met. The Court indicated that in order to resolve the class action questions, it was necessary "at this preliminary stage in the litigation to undertake the difficult though eventually unavoidable task of product and geographic market definition" (501 F. 2d at 645)—the very issues that are central to the substantive determination of antitrust actions. Thus, in dismiss-

ing the appeal, the Court found, as the *Parkinson* Court put it, that

> "examination of the common questions of market competition, economic power, and behavior had an 'obvious relationship to the very issues critical to the success' of the underlying claim, and therefore the order was not 'separable from the merits' " (520 F.2d at 657).

Similarily, in *Kohn* v. *Royall, Koegel & Wells,* 496 F. 2d 1094, 1100 (2d Cir. 1974), the Court held that the "separability" requirement was not met, since in order to resolve the class action issue, which again turned on the "common questions" requirements, it was necessary "to examine not only the factual strength but the legal relevancy of Kohn's allegation of a discriminatory pattern and practice"—issues which were "at the very heart of the merits of this action. . . ."

Again, in *Handwerger* v. *Ginsberg,* 519 F.2d 1339, 1341 (2d Cir. 1975), it was found that the separability criterion was not satisfied, since resolution of the class action issue required a determination on the merits as to whether or not defendants were "entitled to summary judgment against appellee," which of course necessitated "a detailed examination of the merits of the action. . . ." And in *Parkinson, supra,* defendants' argument was "that plaintiffs failed to establish that there is sufficient merit in the plaintiffs' complaint for the plaintiffs to act as class representatives" (520 F.2d at 658)—an argument which obviously required a substantive inquiry into the merits of the action.

The contrast between these cases and the present case is, we submit, evident. The present appeal requires neither a factual inquiry into the merits nor a determination, even on a preliminary basis, of any substantive issues in the

case. What is presented, rather, is a plain and separable issue of law on the important question of conflict of interest. Therefore, particularly if, as Judge Friendly suggested in his concurring opinion in *Parkinson,* the separability requirement is one which is almost always met (520 F.2d at 659), this test has clearly been met here.

Finally, we submit that if this appeal is not heard, what plaintiff concedes to be "serious and important questions" will be effectively immunized from *any* review. This Court recognized in *Herbst* v. *International Telephone & Telegraph Corp.*, 495 F.2d 1308, 1313 (2d Cir. 1974), that "... as appellate judges we would be reluctant to hold that a class action had been improper after the district court and the parties had expended much time and resources although we might have had serious doubts if we had reviewed the question at the inception of the action," and in *Parkinson, supra,* that "deferring review until after the entry of a final judgment may well prevent any effective review at all of the class action designation" (520 F.2d at 653).

We respectfully submit that defendants should not be deprived of effective review of the important questions presented here.

CONCLUSION

For the reasons above stated, and for the reasons set forth in our principal brief, the decision and order of the District Court should be reversed.

Respectfully submitted,

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